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First National City Bank
Monthly Letter

Business and Economic Conditions

New York, September 1960

General Business Conditions

THE economy has moved along on an even keel during the summer months. Slackening of activity during the vacation period fits the regular pattern, and seasonally adjusted indexes are probably showing little change. However, businessmen are increasingly concerned over continued slackness in new orders and the pressures of costs and price competition on profit margins. A mild stimulus to the economy was provided in August by a series of Federal Reserve actions designed to increase the availability of credit.

Attention is now focusing on the fall, when production and trade will feel the force of seasonal expansion. The question is whether the expansion will fully measure up to past performance. Merchants look to the weeks after Labor Day for signs as to the probable dimensions of fourth-quarter trade.

The mixture of strengths and weaknesses in the current situation adds up to over-all stability, but it also provides some striking contrasts. This summer, more Americans have held jobs, and enjoyed larger incomes, than ever before; yet there is a conspicuous lack of the buoyancy and enthusiasm which usually characterize prosperity. A high, stable level of business and steady growth in demand for goods and services by consumers, business, and government have at times been crowded out of the limelight by the spectacular decline in steel mill operations or reports that unemployment had risen above four million through the sheer number of new entrants into the labor force. On balance, cutbacks have been offset by expansion elsewhere.

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"Rolling Readjustment" in Production

In August, industrial activity appears to have shown little change from July, which in turn was unchanged from June. In fact, the seasonally adjusted Federal Reserve index of industrial production (1957 = 100) has been rocking along within the narrow range of 109-110 since February, following the short-lived spurt to a record 111 in January. This is all the more striking since the index of iron and steel production declined more than one fourth from February to July. The offsetting upward movement has been broadly distributed among both durable and nondurable goods industries — a classic pattern of "rolling readjustment."

The decline in steel output appears to have touched bottom in July. Mills boosted operations during August to an average of about 54 per cent of rated capacity, against 50 per cent in the preceding month. The rise was somewhat short of seasonal expectations, partly because of labor difficulties in the Pittsburgh area, but more basically because the anticipated increase in new orders failed to appear. Automobile producers and other steel users are still holding back on orders.

Meanwhile, the best evidence is that consumption of steel has continued at a high level; metalworking activity in July, according to seasonally

adjusted Federal Reserve indexes, was off only about 2½ per cent from its January peak. Yet steel orders continue to lag. The explanation is that users feel in no immediate danger of either shortages or price increases for steel and are reducing inventories to a minimum. The National Industrial Conference Board estimates that fabricators took delivery on one million tons less finished steel than they consumed during the second quarter. By the end of the third quarter, continued liquidation may bring fabricators' inventories down near the low level at the end of 1959. Yet, so long as mills have the spare capacity to make quick deliveries of large tonnages, there is little incentive for steel users to shift from their current hand-to-mouth buying policies or add substantially to stocks.

A New Environment for Inventory Policy

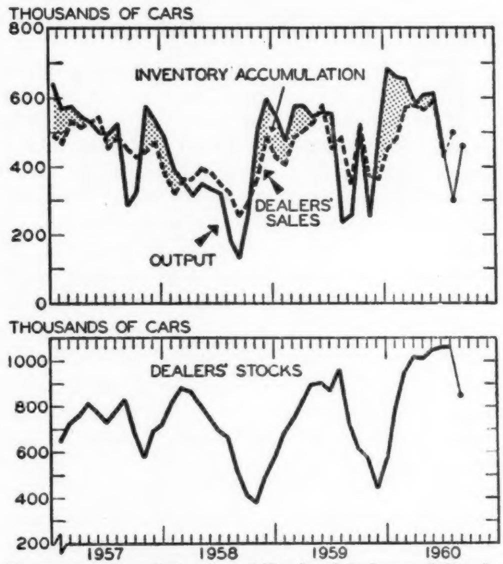
Relative freedom from fear of shortages or inflation during a period of high-level demand has been unusual during the postwar period. Yet such a situation now exists, and is reflected in generally cautious inventory and purchasing policies. High sales volumes have not brought corresponding increases in business stocks to the levels indicated by average stock-sales ratios for recent years. A new and lower relationship of stocks to sales may be in the making, aided by new data-processing equipment and other techniques for inventory control. This change in inventory policy has had a moderating effect on 1960 business; needless to say, economizing on inventories cannot go on indefinitely. Signs of renewed inflation could, of course, make businessmen decide once again to hedge against the possibilities of price increases or shortages.

Price stability is a factor holding down inventory demand at the moment. Indeed, the increasingly competitive situation in many lines has led to shading of quoted prices or delivering extra quality at no added cost. These concessions are often not publicly reported or reflected in the official indexes of wholesale prices.

At the same time, spotty price weaknesses intensify the squeeze on profit margins. Reduced profits hurt both the ability and the incentive for business to undertake capital investment. For the balance of this year, however, the new plants under construction and machinery on order are generally too far along to permit much change in the anticipated levels of business capital expenditures. Whether the new Congress to be elected this November will act, through tax policy, to remove obstacles to industrial capital formation in the years ahead remains to be seen.

Clearing the Decks for the '61 Models

The automobile industry has its special inventory problem. As recently as August 10, according to Ward's Automotive Reports, dealers' stocks of new domestic passenger cars were still more than one million. As shown in the accompanying chart, stocks first rose above the one-million mark in March and stayed there. Since the end of May, new car sales have been at about the same rate as in the corresponding part of 1959; prior to that time, sales had been about 13 per cent higher than a year earlier.



Passenger Car Output and Dealers' Sales and Stocks
New Domestic Passenger Cars Only; Monthly, Jan. '57 - Aug. '60
Shaded areas represent inventory accumulation (plus a small volume of factory sales for export).
Source: *Ward's Automotive Reports* (Rough estimates for August by this bank: production, 300,000; sales, 500,000; stocks, 850,000. September output scheduled at 462,000.)

By the last week of August, the automobile industry had reached about the low point of its model changeover cycle. Only 39,000 cars were produced in the week ended August 27, nearly half of them 1961 models. From this point on, the production trend will be sharply upward, as manufacturers hurry to get their dealers stocked and new models introduced by the time the National Automobile Show opens in Detroit October 15. During September and early October the pressure will be on dealers to move as many as possible of the 800,000 or so 1960 models estimated to be in stock at the end of August. Failure to bring these inventories down to manageable proportions may inhibit the buildup of 1961-model stocks. With an array of new compact cars and restyled standard models, the industry is out to stimulate consumer interest and build sales in the new model year.

Easier Credit

Effective August 12, four Federal Reserve Banks, including New York, reduced their discount rates from 3½ to 3 per cent. Except for Dallas and San Francisco, the other Federal Reserve Banks fell in line during the next two weeks. Like the previous discount rate cut, from 4 to 3½ per cent in June, the move represented an adjustment to the fallen level of Treasury bill yields at a time when there is some slack in the economy and a waning of inflationary pressure. In this situation, enlargement in the supply of credit seemed desirable from the standpoints of increasing employment opportunities and stimulating economic growth.

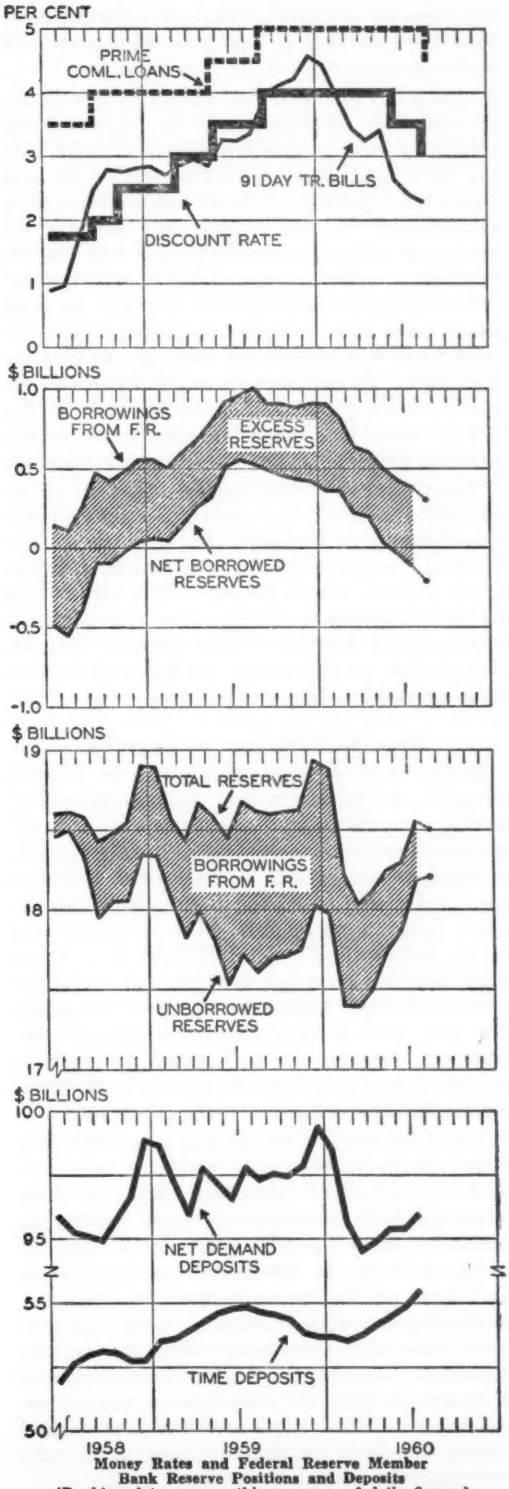
On August 9 — but not effective until August 25 and September 1 — the Federal Reserve Board took a more positive and direct step to make more loan funds available. It was announced that member banks' reserve requirements would be eased to release about $600 million in additional bank cash "for expanding bank credit as the economy enters the season of rising credit needs."

The Board lowered from 18 to 17½ per cent the reserve required against net demand deposits of New York and Chicago banks, releasing $125 million in reserves for these banks and bringing this reserve requirement a little closer to the existing 16½ per cent requirement for reserve city banks. More money is involved in a further liberalization of allowances for vault cash that may be counted as required reserves, making about $480 million additional reserves available to reserve city and country banks but having no real significance in New York or Chicago.

Bank Reserves Replenished

Meanwhile, through purchases of government securities in the open market, the Federal Reserve has carried forward its policy, begun in April, of replenishing bank reserves and thus providing a base for credit expansion. The effects of these purchases are apparent from the third block of the accompanying chart which shows a rise from March to August of about $500 million in total member bank reserves and $800 million in unborrowed reserves (the amount of reserves the member banks have of their own, free and clear of needs to borrow from the Federal Reserve). The lesser rise in total reserves reflects the use by banks of additional funds to reduce their borrowings.

As the second block of the chart brings out, daily average borrowings from the Federal Reserve have dropped to about $300 million. Since June, borrowings have been running below ex-



Money Rates and Federal Reserve Member Bank Reserve Positions and Deposits
(Banking data are monthly averages of daily figures)

cess reserves so that the banks, for the first time since 1958, are back in a position where they hold some free reserves.

The prime loan rate (the minimum rate on unsecured loans to borrowers of the highest credit standing) was cut from 5 to 4½ per cent by leading New York banks, effective August 23, and banks throughout the country followed suit. The groundwork for the change was laid by the easing of Federal Reserve policy and by the decline in money rates and bond yields which invited business borrowers to rely less on bank loans and raise more funds through sales of open market paper or bond offerings. Thus, some weakening has become apparent in bank loan demands since June. But what tripped off the action more than anything else was the impending effect of lowered reserve requirements.

Many observers were surprised that the prime loan rate reduction had not come sooner. What these observers overlooked was that the shift in Federal Reserve policy, in April and May, began from a point where banks were strapped for funds and forced to sell investments at losses to cover deposit shrinkage, meet essential loan demands, and curtail use of the Federal Reserve discount window to avoid criticism.

Sluggish Response of Deposits

Bank loan volume continued to expand through the June tax date and even now is holding near that peak level. Meanwhile, the response of deposits and calculated money supply to the easing of Federal Reserve policy has been slow and sluggish. As the bottom block of the chart shows, time deposits have recovered and finally pushed beyond the July 1959 peak. These deposits involve added interest cost and their growth does not encourage loan rate reductions the way that demand deposit expansion can. Demand deposits, as the chart shows, have moved up modestly from the March low but still remain far below the average level of 1959.

The slow reaction of demand deposits to the easing of Federal Reserve policy is explained by the practices of depositors. Many of them converted bank balances into open market investments when short-term Treasuries were offering yields in the market of 4 to 5 per cent, and subsequently have hung on to their investments or, upon maturity, have accepted lower rates and reinvested. With the laggard behavior of deposits, the Reserve Board was wise to bring into play the reductions in reserve requirements. Desirable as a matter of fundamental reform, they have the practical merit of directly increasing the availability of bank credit.

Fiscal Policy Reviewed

The postwar years have seen rather general acceptance of the idea that policies of the Federal Government — both fiscal and monetary — should be directed toward moderating the fluctuations of the business cycle while promoting high-level employment and production, economic growth, and price stability. This is a large order, and there has been considerable difference of opinion on whether these objectives are all consistent with one another. Above all, there is continuing lack of agreement on the specific measures government should take to achieve these general purposes.

One problem has been to find ways for government to use its powers constructively without impairing the capacity or incentives of private business to function effectively. All too often, in considering the role government can play, it is forgotten that most job opportunities in our society are provided by private employers. A constructive fiscal policy should strengthen incentives which lead enterprising people to offer employment opportunities and foster price-cost relationships which permit production and sale at a profit. Otherwise, "full employment" would mean everyone working for the government.

A question that has received more attention in the past few years is whether a government policy committed by law "to promote maximum employment, production, and purchasing power" can be reconciled with price stability. People have become increasingly aware that maintaining high levels of demand for labor and goods creates both the opportunity and the temptation for labor and business to raise wages and prices. There has also been recognition that excessive, poorly timed, or badly chosen anti-recessionary measures can leave a legacy of inflation once the recession is over.

On the whole, our postwar monetary and fiscal policies have served reasonably well in maintaining high levels of activity. The three recessions which have occurred since World War II have all been relatively mild. The most probable reason we have suffered nothing worse is that we have taken some pains, in each period of boom, to restrain inflationary pressures. Tax reforms helped cushion the recessions of 1948-49 and 1953-54. In the 1957-58 downturn, however, tax reform proposals were shelved in favor of increased federal spending. In each case monetary measures were put in force to ease credit availability and enlarge the money supply.

The policies pursued in the 1957-58 recession gave us a lot of trouble. The federal cash deficit of $13 billion in the fiscal year ended June 30,

1959 – a red ink figure beyond any precedent in peacetime – disturbed the faith of people, at home and abroad, in the future value of the dollar. As soon as credit policy moved toward restraint, bond prices collapsed under the weight of undigested Treasury security offerings. The gold outflow which began in early 1958 has been sharply reduced but not yet entirely stopped. A balance-of-payments problem is still with us. It is true that tightened money and federal spending policies quieted inflationary fears, but the cost of living has continued to edge higher.

There must be some way to do better.

Professor Burns' Views

In this connection, a notable analysis of economic developments and fiscal policies was made in a speech last spring at the University of California by Columbia Professor Arthur F. Burns, former chairman of President Eisenhower's Council of Economic Advisers and our outstanding expert on business fluctuations.

Professor Burns emphasizes the inflationary results of poorly timed expenditures made to fight the 1957-58 business slump:

> Wages moved up in the face of considerable unemployment. So too did prices at wholesale and retail despite extensive idle capacity in our mines, factories, and shops. And although the economy was advancing vigorously once again by the end of 1958, the cash deficit of the federal government was still mounting. In addition, the large increase of the money supply which occurred during the recession was still being extended.

These signs added impetus to an inflationary psychology that could have led to a speculative boom, and eventually to economic collapse. Moreover, the loss of gold reinforced foreign concern over the future of the dollar:

> Unless we succeeded in reassuring foreign investors about our economic policies, we ran the risk that external confidence in the dollar would be shaken, that billions in foreign assets held here would be repatriated after being converted into gold, and that the resulting financial crisis would threaten our political and military leadership of the Free World.

Fortunately, the Administration, with a surprising degree of support from the Congress, directed its energies at rebalancing the federal budget by holding back further increases in expenditures while the revenues caught up. The Federal Reserve applied a restrictive credit policy, advancing discount rate from 1¾ per cent to 4 per cent. As Professor Burns comments, fiscal and monetary policies became more restrictive than is commonly realized. With the achievement of a federal budget surplus in the fiscal year which ended June 30, and the enthusiastic public response to the Treasury's offer of rates as high as 5 per cent on its new issues, the worries of people about the dollar were relieved. As the successive reductions in Federal Reserve discount rates show, it has become safely possible for the authorities to make credit policy less restrictive. With improvement in demand for bond investments, Treasury borrowing costs have been reduced.

From the effectiveness of these restrictive policies, Professor Burns draws a practical lesson:

> . . . they demonstrate that while the forces making for inflation are strong in our times, they can be brought under control if public and private policies are directed resolutely toward this objective.

But any victory over the forces of inflation must be regarded as merely temporary. In the United States, the Government is firmly committed to act against any recession. We are therefore always in danger of touching off further inflation.

Dealing with the next recession, Professor Burns points out, will be complicated by the need to protect our international financial position. Our balance-of-payments deficit has "diminished our effective range of freedom in dealing with recessions." A sharp easing of credit by the Federal Reserve could lead to another massive outflow of gold if interest rates remained higher in money markets abroad. Moreover, if foreign bankers and investors should come to suspect the soundness of our policies, speculation about a future devaluation of the dollar could lead to a "gold crisis."

Need for Forward Planning

Thus, Professor Burns suggests, we must consider well in advance ways to counteract a future recession without the extremely easy money conditions that we had during earlier postwar recessions. Lack of a planned program does not mean that no action would be taken, but rather that, as in 1958, spending measures probably would be piled one on top of another in piecemeal fashion until the total spending bill would exceed that of even an extreme program planned in advance.

One measure suggested is reform of the unemployment insurance system on a national level, enlarging benefits and extending eligibility periods. This, Professor Burns states, could offset more effectively the loss of wage income stemming from recession and help guard against inflationary adventures by permitting calmer discussion of policies to restore economic activity. This suggestion runs up against regional differ-

ences in incomes and living costs. There is always the problem of setting unemployment compensation rates at levels that will not invite abuses and subtract from the availability of people for work.

Professor Burns evaluates the alternatives of tax cuts or increased federal expenditures to support economic activity and comes out strongly for reducing tax rates. Increased expenditures, he points out, "tend to become permanent, or at least to outlast the reason that brought them into being." This has happened all too often.

More important, it takes considerable time before government spending decisions take effect, while a tax reduction can loosen private purse strings and stimulate enterprise at once. In the 1958 recession, Professor Burns points out:

> The main impact of the federal spending programs that were then inaugurated came after the recession was over. The cash deficit of 13 billion dollars occurred in the fiscal year which ended last June — a year of continuous business expansion, not in the preceding fiscal year when the economy was depressed.

Moreover, investors both here and abroad are likely to have more confidence in our Government's financial policies if we stimulate private spending — especially investment — by means of tax reform rather than by boosting public expenditures. Foreign countries, which themselves have undertaken tax reforms and have seen their benefits to enterprise, can understand their propriety here, particularly if the reforms apply to excessive rates that deter tax-paying enterprise and hence hurt the revenues.

The Tax Question

Tax changes are needed, not only to check recessions, but to help speed our economic growth. Professor Burns emphasizes the great risk we run in keeping a tax system that not only discourages enterprise and investment, but also "diverts the energy of some of our ablest citizens into channels that may bring a tax advantage to them or their firms but do little or nothing to raise the nation's productivity."

He contrasts our continued acceptance of a stultifying system of taxation with the measures adopted by the Russians to promote individual effort with appropriate rewards:

> . . . the Russians have in recent years been very methodical in creating large income inequalities. In particular, they reward handsomely their managers, scientists, teachers, and the more skilled factory workers. But while they have been devising special incentives to spur productivity, thereby adopting the practices of our older capitalism, we have adopted a tax system that weakens the incentive to create and produce.
>
> Can it be that the Russians have rediscovered one of the main secrets of Western economic success, while we have allowed our idealistic impulses to obscure the sources of our own great achievements?

Depreciation Allowances Here and Abroad

A good deal is being said in this national election year about the needs for stimulating the growth of the American economy. In specific terms we hear most about "starvation of the public sector" — shortages of schools and roads and manifold other things provided by government. This emphasis on public spending leads to higher and higher taxes. The taxes, as a practical fact of finance, constrict the opportunities of business to expand. And expansion of private enterprise still remains the primary reliance of the American society in holding its leadership in a competitive world.

There are abundant illustrations — as in the rejuvenation of enterprise in Europe — that wise and realistic tax policies can pay rich dividends in economic progress and human welfare. In comparison with our federal tax structure, European taxation is heavier on consumption and lighter on work and capital accumulation. While seemingly directed against consumption, this structure of taxation strengthens inducements to work, ability to accumulate capital, and capacity of industry to compete in world markets. A bigger economy in turn means more goods available for consumption.

If we genuinely want to speed our economic growth, tax reform is the obvious fuel to use.

As is becoming more widely recognized, the sorest point of our federal tax structure lies in excessive income tax rates. With reforms abroad, we get left behind with an archaic tax structure seemingly and strangely dedicated to hampering our growth. The relative severity of taxation of corporate income in the United States was brought out in "Taxation of Corporate Dividends" in our July issue. There are also aspects, apart from rates, in which U.S. business has harsher tax rules to live by than is true abroad. Foremost in this connection is the matter of allowances, in calculating income tax liability, for depreciation of capital assets.

The importance of liberalized depreciation has been recognized all over the world because of its influence on investment which in turn is the core of the growth process. Business finances capital investment from a variety of sources — sales of stock, borrowings, retained earnings, and depreciation allowances. The biggest source is

depreciation which, if earned, gives back to a company a portion of its past investments. The more freedom a company has in the timing of depreciation charges, the more opportunity it has to grow. One of the considerations dictating liberalization of depreciation rules is the fact that, in this age of dynamic change mixed up with inflation, large amounts of capital, beyond depreciation allowances, must be poured into a company to replace its plant and keep up with the times.

Industrial firms find that allowances made for depreciation in the past two decades fall far short of meeting replacement needs at current inflated costs. George Terborgh, research director of the Machinery and Allied Products Institute, estimates that costs of replacement are outrunning depreciation allowances in American industry by $6 to $8 billion a year. A distinguished accountant, Professor William A. Paton of Michigan, has put the total bill for capital replacement not covered by tax write-offs at $40 to $50 billion since World War II. Testifying before the Ways and Means Committee last fall, he said:

> Plant assets don't grow on the bushes; they must be provided either from business revenues or from the additional savings of investors. And it seems very clear to me that restricting the depreciation deductions to the number of dollars invested, regardless of dates of acquisition and the varying values of the dollars, makes it impossible to replace the plant capacity consumed, to say nothing of expansion of facilities, without drawing on net earnings as reported or raising additional capital.

Another factor is the increased rate of obsolescence. With the transformation of manufacturing methods, and introduction of new products developed out of research, capital equipment gets out of date or becomes economically useless long before it wears out physically. A survey by McGraw-Hill indicates that the costs of replacing facilities that are presently obsolete would amount to about $95 billion. And the rate of obsolescence is expected to increase in coming years. One expert has forecast that machine tools installed in the next decade will typically become obsolete within five years; in the 1940's, machine tools could be used twice as long before becoming outdated.

Stringency of U.S. Rules

In comparison with foreign tax allowances for depreciation on machinery and equipment, U.S. tax allowances stand out as particularly restrictive. This stringency is a matter of increasing national concern as American producers are confronted with increasing competition from foreign manufacturers who can now combine cheaper wage costs and easier income tax rates with faster tax write-offs of the most modern machinery. Though no new legislation has been adopted, criticisms of U.S. depreciation allowances have found sympathetic understanding in the Treasury and in the Congress. In January, the Senate Select Committee on Small Business issued a Report on *Tax Depreciation Allowances on Capital Equipment* which went far beyond the impact on small business. The Committee reached the broad conclusion that:

> Present depreciation policies do not sufficiently encourage the expansion of the national economy. Indeed, those policies have, in all probability, stifled economic growth.
>
> The twin problems of inflation and technological obsolescence . . . have made our depreciation policies completely out of date. . . .

In this country, a serious barrier to more liberal depreciation practices is the fact that Bulletin F, most recently revised in 1942, is still the only formal guide provided by the Internal Revenue Service for reckoning depreciation rates. This publication gives estimated useful lives and depreciation rates of machinery and equipment for tax purposes. Though taxpayers are virtually invited to justify and use lives shorter than those published, many small taxpayers and tax agents apparently still regard Bulletin F as definitive.

We gain some idea of how restrictive our practices are by noting some key examples contained in Bulletin F. Machinery and equipment in the metal products industries, for instance, are typically given composite lives ranging from 15 to 25 years, with the minimum in only one industry as short as 10 and the maximum in another as long as 30. Useful lives of 15 to 25 years are equivalent to depreciation rates of 6⅔ to 4 per cent on a straight-line basis or 13⅓ to 8 per cent when calculated on the declining-balance method authorized for new property since 1954. The iron and steel industry is given a composite life of about 25 years.

In contrast to these long useful lives and low rates of depreciation, governments abroad have established much higher depreciation rates permitting faster write-off of new investment. And many governments go even further. Some have permitted revaluation of asset values – and hence depreciation allowances – in order to recognize the higher replacement costs resulting from inflation. Others grant investment allowances over and above original costs, thus giving total deductions greater than the historical cost of a machine. More broadly, the acceleration of depreciation by special allowance is common practice in most European countries. In some cases, these special provisions permit deductions in the year of investment approaching half the cost.

The following paragraphs give briefly the major features of the laws and practices in some of the principal industrial countries in Western Europe.* They provide working examples of the range of possible measures that might be adopted for our own use.

United Kingdom

Though the United Kingdom is regarded as having the least liberal depreciation allowances of the European countries, its practices are far more encouraging for private investment than those of the United States. Basic rates, developed in consultation with various trade associations, are set at 7½, 10, 12½, and 20 per cent for various categories of industrial machinery and equipment. Applied on a declining-balance basis, they are increased by one fourth; this makes the effective rates 9⅜, 12½, 15⅝, and 25 per cent. Individual companies, it should be noted, are not firmly bound to these schedules and may be able to justify higher rates.

Over and above the regular rates, additional tax inducements to investment are offered — "investment allowances" and "initial allowances." An investment allowance is given over and above the original cost which can be recovered in full irrespective of the investment allowance. An initial allowance is available, in the first year, against the original cost, in addition to the regular allowance. In subsequent years the regular allowances are applied to the cost thus reduced. In the years since the war there have been numerous changes in these two allowances, intended to achieve both counter-cyclical stabilization and long-run increases in investment.

Among the combined allowances established in 1959 and unchanged in the April 1960 budget, is an investment allowance of 20 per cent plus an initial allowance of 10 per cent on new machinery and plant. For machinery receiving the basic 12½ per cent rate, this gives a total allowance in the year of acquisition of 45⅝ per cent, made up on the declining balance basis as follows: 20 per cent investment allowance, 10 per cent initial allowance, and 15⅝ per cent regular depreciation based on 1¼ times 12½ per cent. If the basic rate were 10 per cent, the first year allowance would still be 42½ per cent.

In sum, the most striking features of British depreciation practice are the use of broad categories of depreciable property and the extremely liberal allowances in the year of acquisition.

France

On the whole, depreciation practices in France are more liberal than in the United Kingdom. France, besides providing initial allowances for new investment, permits more rapid rates of write-off and also revaluation of property to compensate for past inflations.

Allowable rates of depreciation for each individual company are subject to determination on the basis of the particular operation. But tax officials have published rates appropriate for various industries that have been agreed upon after discussion with trade associations. These rates can be counted on as acceptable to tax officials. Ordinary machinery is given a 15 per cent rate on a straight-line basis, a rate of write-off consistent with a life of less than seven years. When such machinery is used for multiple-shift operations, the rate may be increased to 20 or 30 per cent.

On top of this, a double allowance is given in the first year. For ordinary machinery, this means a 30 per cent allowance with the remaining 70 per cent depreciable at 15 per cent of original cost and written off in less than five more years. Heavy machinery, such as steel mill equipment, is given a 10 per cent rate, also with a double allowance in the first year. In addition, for various classes of machinery, an initial allowance of 10 per cent is given.

Last December, France went even further by authorizing depreciation on a declining-balance basis. Under this system, straight-line rates may be increased by 1½ times for property with a life of three or four years, doubled for a life of five or six years, and raised by 2½ times for lives of more than six years. If used, these higher rates supplant the initial allowance and double allowance in the first year. They result in a lower deduction in the first year, but higher allowances in the second and third years. Under the straight-line system, property with a 10 per cent rate would get 28 per cent of cost written off in the first year (10 per cent initial allowance plus double the 9 per cent allowed on the balance of cost spread over ten years) and 9 per cent in each succeeding year. Under the new method, however, the allowances in the first three years would be 25, 18.8, and 14 per cent, respectively, or a total of 57.8 per cent in the first three years, compared with 46 per cent under the previous method.

Aside from rapid recovery of original costs, France also permits revaluation of assets by applying factors ranging from 1.0 for assets acquired in 1959 to 243.0 for assets dating back to

*Adapted from a private memorandum prepared by Professor Dan Throop Smith of the Harvard Graduate School of Business Administration and formerly Deputy to the Secretary of the U.S. Treasury (in charge of tax policy).

1914 and earlier, and in the case of inventory from 1.0 for 1959 to 388.9 dating back to 1914 and prior years. These factors are applied to both historic cost and annual depreciation allowances since the date of acquisition. Even property written off completely can have a restored value for additional depreciation.

Germany

Tax policies to encourage private enterprise, beginning in 1948, played a central role in the dazzling recovery of the German economy. Apart from easier rates of tax than we apply, the German industry is permitted more rapid write-off of new plant.

Following the Currency Reform Act in 1948, revaluation of assets was authorized for depreciation and tax purposes and special initial allowances for new equipment, running up to 50 per cent, were brought into play for a number of years. These have now lapsed.

Regular depreciation rates in Germany are determined in the light of the particular circumstances of each taxpayer, but two years ago a series of allowable rates were published as guidelines. Taxpayers can count on these rates being accepted, but they may use even higher rates if they can justify them. For machinery, a basic rate of 10 per cent is common for straight-line depreciation. But under a declining-balance formula, this may be increased by a multiplier of 2½, thus giving a write-off of 25 per cent in the first year and about 58 per cent of cost in the initial three years. The government recently has recommended to the legislature that the multiplier be pared to 2 on the idea that the allowance is unnecessarily generous and has contributed to excessive pressure on capital goods industry.

Sweden

Wide leeway in the timing of deductions has long been a distinctive feature of depreciation practice in Sweden. Up to 1956, business was permitted complete freedom; any amount up to the full cost of plant, machinery, and equipment was allowed in any year at the taxpayer's discretion. This system of "free" depreciation was regarded as the ultimate in liberality.

The freedom was somewhat curtailed four years ago. Two alternative methods are now used: depreciation according to plan and depreciation on a bookkeeping basis. Basically, a write-off rate of 20 per cent (consistent with a five-year life) can be applied to the historic cost of plant and equipment. On the bookkeeping basis, the taxpayer may write off 30 per cent of book value at the beginning of the year, plus the cost of acquisitions and minus any realizations during the year. If this formula fails to yield a write-off of 20 per cent, then the taxpayer may use 20 per cent of historic cost as his depreciation rate. The principal requirement in using this formula is that the taxpayer use a method of bookkeeping that will permit gains from sales of depreciated assets to be brought into account.

But beyond liberal depreciation of actual cost, Sweden permits a tax deduction of up to 40 per cent of net income for reserves to stabilize economic activity. Forty per cent of the amount deducted (or 16 per cent of profits) must be invested with the central bank, for use as permitted depending on the level of economic activity and employment. The company is free to use the rest of the money as it sees fit.

Such liberal treatment of investment does not represent favored treatment of "big business." Sweden's programs were all developed under a labor-socialist government with the aim of increasing productivity through more investment.

Belgium, the Netherlands, and Italy

In Belgium, assets for depreciation purposes are grouped in broad categories with rates ranging from 10 to 25 per cent for machinery. In 1954-56 and again since 1959, special investment allowances of up to 30 per cent have been granted. These have been limited to new ventures or very large expansions of existing plant.

In the Netherlands, both initial and investment allowances are used to spur investment. Since 1949, initial allowances have been 33⅓ per cent with varying requirements for spreading the allowances over the early years. Both the initial allowance and regular depreciation may be taken from the time that a contract is placed, not, as with most countries, when it is actually put to use. Depreciation allowances which are not covered by profits in any one year may be taken in succeeding years.

In Italy, the rates of depreciation as laid down by the tax authorities vary from 3 to 20 per cent per year. However, accelerated depreciation on new plant is provided for by a form of initial allowance which reduces the normal depreciation period by two fifths. This 40 per cent "initial" allowance may be spread over the first four years of the life of the asset (subject to a 15 per cent maximum in any one year) in addition to regular depreciation.

The Road to Economic Progress

From this review the lesson emerges that tax policies are critically important to the economic

strength and growth of any country that looks upon private enterprise to provide the bulk of the jobs and the national product. In the United States people bemoan failures to realize greater economic growth while neglecting tax problems crying for attention.

It is worthy of comment that even socialist governments have pursued liberal policies in the matter of depreciation charges. This was true, for example, under the former Labor government of England as it has been in Sweden.

The German Economics Minister, Ludwig Erhard, in his book, *Prosperity through Competition*, cuts to the core of the matter. Referring to the near doubling of the real national income of Germany, 1949-56, he wrote:

> This measure of the undisputed success of the policy demonstrates how much more sensible it is to concentrate all available energies on increasing the nation's wealth rather than to squabble over the distribution of this wealth, and thus be side-tracked from the fruitful path of increasing the national income. It is considerably easier to allow everyone a larger slice out of a bigger cake than to gain anything by discussing the division of a smaller cake.

$125 an Hour

In last month's Senate debate over the proposal to raise the minimum wage from the current $1 an hour to $1.25, one Senator inadvertently called for lifting the minimum to *$125* an hour. The slip of the tongue was greeted with some merriment on the Senate floor. Nevertheless, it affords occasion for some reflection on principles. If the government can improve the lot of the working man by fixing a minimum of $1.25 for an hour of work, why stop there? *Why not* $125 an hour? A look into this extreme example serves the purpose of unveiling some of the less attractive aspects of minimum wage legislation. All is not milk and honey.

A raise in wages of a hundred times would mean a 99 per cent decrease in the labor equivalent of a dollar. At $1 an hour, a dollar will pay for 60 minutes of a man's time; at $125 an hour, it would pay for a fleeting 29 seconds. Even the humblest workman could find himself in the 91 per cent federal income tax bracket. With all the other taxes, state as well as federal, he might as well figure on paying pretty much the whole amount over to government. This is an easy example of the insidious way that inflation raises effective tax rates even though the nominal rate structure stands still.

But before the workman gets his money there is the practical problem of how employers would ever meet their payrolls, multiplied by 100.

If there were not to be a complete cessation of economic activity, the government would have to work overtime printing the money and somehow getting it out into the hands of employers. And prices of everything would have a couple of zeros added so that business income could equal outgo. It would be a sort of currency devaluation. The dollar would become a penny; the penny, valued for its copper content, would disappear from circulation.

Working people's higher wages would leave them no better off; they would actually lose because the value of their savings, insurance, and pension rights would be reduced by 99 per cent. Millions of others, including the sick and the aged, would be forced to seek charity, the fruits of their lives' work eaten away by inflation. Capital funds painstakingly saved over the years would have to be dissipated for daily essentials costing 100 times more.

We all know that nothing like this is going to happen here — even though it has elsewhere in the world.

Nevertheless, the example makes the point that there is no royal road to riches in minimum wage decrees.

Administered Inflation

The Senate debate brought up many of the practical effects which even moderate increases in minimum wage will have. A query by Senator Goldwater, why not $2.25 an hour?, brought the response from Senator Kennedy, the bill's chief sponsor, that such an increase "would be self-defeating" or "cause massive unemployment."

The bill, as approved by the Senate, would raise the minimum wage from the present figure of $1.00 an hour to $1.15 in 1961, $1.20 in 1962, and $1.25 in 1963. If enacted, successive raises will have lifted the minimum from the original 25 cents in 1938 to $1.25 in 1963 — an average increase of 6.9 per cent a year, compounded. The suspicion grows that these successive step-ups in minimum wage are part and parcel of a policy of administered inflation. It should not be forgotten that the welfare of people can be better and more uniformly improved by price reductions which, growing out of better labor productivity, make the dollar a heavier, more valuable, and more highly respected coin.

The avowed purpose of a federal minimum wage is to prevent unjust exploitation of the working man or woman. This principle is compromised, however, by the numerous exceptions in the coverage of the law, some on Constitutional grounds, some as a concession to particular industries like farming. The trend has been,

of course, not only to raise the minimum but to reduce the exceptions.

It should go almost without saying that most large employers have comparatively few workers around the minimum wage level. Nevertheless, the rise in the minimum tends to spread upwards as employers and workers try to preserve normal differentials between job classifications. The prediction seems reasonably well-founded that further increase in the minimum will insure continued upward pressures on consumer prices, already at a record-high level.

Work at minimum wages is most common in small communities or parts of the country where living costs are cheap and a less harried pace of life offers freedom from the costs and troubles of commuting to work. Federal minimum wages reduce employment opportunities in such areas, as studies of the effects of earlier increases in the minimum show. Minimum wages specifically bear down on the formation and growth of new business ventures, financed out of limited pocketbooks.

The Wage Minimum and Unemployment

If we want to keep raising the minimum wage so rapidly, we not only must accept the prospect of continuing inflation but also must be willing to shoulder the social costs of added unemployment and increased difficulties of young people finding their niches in life. Learning to work is a most essential part of education. The beginner, with all the help and instruction he requires, has trouble really earning any rate of pay.

The problem of providing jobs for growing numbers of young people in the coming years was foreshadowed this past summer when estimated unemployment moved up to an aggregate beyond four million persons as hundreds of thousands of school boys and girls began looking for jobs and encountered difficulty finding them. With a higher wage floor and a narrowing of exempt occupations, their difficulties will be compounded.

Minimum wage laws reduce job opportunities for beginners, for people without developed skills, for seekers of temporary or spare time employment. Then there are the inevitable numbers who, for lack of industrious habits, have so little to offer a prospective employer that pay of as little as 75 or 90 cents an hour would be an act of charity.

The *New York Herald Tribune* commented editorially on the new bill:

> It . . . means some disemployment. The cost squeeze leads to the laying off of less productive workers and the closing of marginal firms. Mr. Meany says an employer who can't pay the minimum wage shouldn't be in business. Maybe so, but the cruel fact remains that when he goes out of business his workers lose jobs that they want to keep. And there are workers who don't turn out $1.25 worth of work an hour. Who's going to hire them?

The young, the inexperienced, and the unskilled already dominate the unemployment rolls today. In an age of automation, untrained hands are needed less and less. The higher the minimum wage and the wider its application, the fewer their opportunities.

The Senate bill would extend the reach of the minimum wage law to about four million additional workers, mainly in retail and service fields. The practical question comes up as to how many of these jobs might be eliminated. These are the areas where the inexperienced have had the best chance to get a start, learn how to work in a disciplined way, and qualify either for promotion or opportunities elsewhere. If merchants must pay more, they naturally will be more careful to get fully competent help, cut down on services rendered, and widen their use of vending machines.

It can be said that the displacement of labor by machines is the key to economic progress. But there is enough technological unemployment already in our dynamic economy without arbitrary increases in minimum wages that unnecessarily push off onto the unemployment rolls people of limited skills and competence who want to work and need the money.

The inflationary aspect becomes more clearly apparent when complaints about excessive unemployment are translated into demands for more government spending and cheap money policies to create more jobs. These policies may become effective in restoring job opportunities but only after prices have risen enough to permit employers to pay substantially higher wages.

We would be wiser if we recognized that the advancement of the American economy, and its competitive power in world markets, rest not on decrees of higher minimum wage levels, but on the fullest use of all the talents we have. The only way for a nation to raise wages is to produce more, to work harder and more efficiently. Certainly for the great, growing body of senior citizens, living on pensions and on past savings, there is nothing more important to peace and contentment than stabilization in the buying power of the dollar.

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